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Trade in Central and Eastern Europe**

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External Financing, Conditionality and Trade in Central and Eastern Europe*

RENZO DAVIDDI & EFISIO ESPA**

Summary

The paper argues that Western aid in favour of Central and East European countries during the past three years, although relevant in quantitative terms, does not seem to be on the order of magnitude which would have been necessary to reduce the hardship of the transition and to support and consolidate newly-elected democratic governments in those countries. Despite the speed in implementing new institutions and programmes and the involvement of the IMF and the IBRD, Western intervention has fallen short of many of its objectives. The aid effort seems poorly co-ordinated, and a clear conflict has emerged between the emphasis put by multilateral organizations (the IMF in particular) on short-term stabilization and the long-term nature of the overall economic transformation in Central and Eastern Europe. Furthermore, West European markets have not been opened to competitive Eastern exports the way it would have been necessary in order to sustain income levels and to give alternative outlets to products no longer exportable to former CMEA markets.

Journal of Economic Literature Classification Numbers: F13, F35.

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1. Introduction

The former socialist bloc is currently pervaded by ethnic strifes and nationalistic tensions, conflicts of various intensity, which have brought about killings, mass deportation and whose extent and gravity has been substantially underestimated by Western governments and institutions. The creation of market economies on the ashes of central planning was thought to be by many a straightforward process, and the costs associated with it relatively minor.

On the contrary, the speedy adoption of free-market principles in the countries of Central and Eastern Europe (CEE)¹ has entailed human and economic costs that turned out to be much higher than originally envisaged. The collapse of central planning and of the old regional trade system, coupled with tough adjustment programmes, have brought about a further reduction of already quite poor living standards. Private consumption has declined in most countries, as did the provision of public services, whose quality, moreover, is negatively affected by the adoption of restrictive fiscal policies.

The dramatic reduction of output after more than three years from the adoption of stabilization programmes in all CEE countries sums up to over 30% with respect to 1989. Despite signs of weak recovery in some countries (notably Poland, the Czech Republic and Hungary), unemployment is on the rise, with 6.5 million people registered as unemployed in the area, with rates ranging from 5% in Czechoslovakia (but with huge regional differences) to 14% in Poland. Even more worrying, the number of unemployed is unavoidably bound to increase, with the proceeding of restructuring and privatization. The social tensions implicit in such a situation can be exacerbated by the lack, or at best, the rudimentary functioning of social safety nets. Meanwhile, the number of people living below the minimum subsistence income has increased dramatically.²

Indeed, after the decision by Central and East European countries to move towards the creation of market economies, and towards a closer integration into the world economy, Western nations and multilateral institutions seemed aware of the necessity to channel substantial flows of resources towards CEE countries and to offer a sufficiently clear perspective of a full integration within the European Communities (EC) institutions. This awareness and the most immediate answers which came from the individual efforts of some of the most industrialized countries and from the EC were not followed by any significant strategy of financial intervention and of trade opening.

In the last three years bilateral and multilateral financial and technical assistance has been directed towards CEE countries from an increasing

variety of sources: the G-24, the IBRD, the IMF, the European Bank for Economic and Development (EBRD), the European Investment Bank (EIB), the OECD and the Economic Commission for Europe of the United Nations (UN-ECE). This intervention, however, although not irrelevant in quantitative terms, does not seem to have been on the order of magnitude which would have been necessary for reducing the hardship of the transition and for supporting and consolidating newly-elected democratic governments. Furthermore, the effort seems poorly co-ordinated, and a clear conflict has emerged between the emphasis put by multilateral organizations (the IMF in particular) on short-term stabilization and the long-term nature of the overall economic transformation in Central and Eastern Europe.

In the meantime the attempt by the CEE countries to intensify trade relations with Western industrialized countries finds an obstacle in Western protectionism. Sectors and products most heavily affected by trade barriers, especially in the EC markets, are those on which, in the short run, CEE countries seem to rely more to gain shares in Western markets (i.e. iron and steel, textiles, agriculture).

The aim of this paper is to substantiate those claims. In the next section some basic results from the economic literature will be recalled, to show that, even in the CEE experience, the determinants of foreign assistance can be mostly explained in terms of advantages for the donor and recipient countries. The dimensions and the most prominent features of Western intervention are discussed in section 3. Section 4 discusses the issue of conditionality – i.e., the link between granting of financial assistance and macroeconomic adjustment policies set by the IMF – while section 5 puts forward a critical assessment of Western intervention in Central and Eastern Europe so far. Finally, section 6 highlights the limits of a mere transfer of resources, identifying the need to create conditions for an effective trade liberalization on the part of the West. Some concluding remarks summarize the main findings of the paper.

2. Determinants of foreign assistance

In the literature, there are several different definitions of foreign financial assistance (FFA). Some only include multilateral and/or bilateral grants, whereas at the other extreme, commercial loans are sometimes considered as part of FFA, as it is possible to calculate a grant element in the loans themselves. FFA can also include in its domain the provision of technical and human assistance, though this can raise serious problems of quantification. The latter has become increasingly important in the development literature since the studies on human capital by T. Schultz and

G. Becker in the late 1950s and early 1960s. There is, however, sufficient consensus as to the fact that FFA should include any financing made at non-market conditions. This is the definition adopted by the OECD in its annual review of development cooperation and it is also the definition used throughout this paper.

Motivations for access to foreign financial assistance are widely discussed in the economic literature. The FFA debate has involved both basic questions (e.g. does foreign aid have a clear and unconvertible role in fostering economic development?) and more specific aspects (e.g. degree of conditionality, estimates of required external resources, project vs. programme aid, self-reliance and aid dependence).³

The early discussion was characterized by a sufficiently broad agreement as to the benefits and aims of external assistance: the main argument centered on the idea that aid – despite its relatively minor importance in quantitative terms – was essential to overcome those bottlenecks and constraints which inhibited higher growth rates. The accepted and dominant model of underdeveloped economies stressed the dependence of income growth on investments, which in turn is a function of domestic savings; at the same time, the popular “two-gap” models stressed the importance of the import-foreign exchange constraint (FE gap)⁴ while attention was also paid to the capacity to absorb foreign capital.⁵

From a theoretical point of view, the literature stresses the existence of a savings gap as an obstacle to development (i.e. a country does not have the amount of savings needed to finance the investment necessary for achieving a pre-determined GDP growth rate) and of a foreign exchange or imports gap (i.e. a country lacks the necessary amounts of hard currency to pay for those imports, mostly investment goods, without which the system enters a bottleneck). The existence of a savings gap in CEE countries is a matter of controversy. While Central-Eastern countries have suffered and, in most instances, still suffer from the presence of excess savings, the ‘forced’ and somewhat artificial nature of this excess liquidity (given the existence of goods shortages) means that current non-consumed income could be easily wiped out (or significantly reduced) given an improvement in the availability of consumption goods. It may also happen that price liberalization and the consequent price increases would take care of the so-called “monetary overhang” and therefore of a part of the savings stock. This seems to have been part of the 1990 Polish stabilization experience.

At the beginning of the transition period, CEE economies seemed to fit the foreign exchange gap interpretation. They were characterized by a chronic shortage of foreign exchange, and they needed to service the massive external debt and pay for both more technologically advanced investment goods and for socially necessary consumption goods. The

foreign exchange scarcity was indicated by the existence of currency black markets, by the rates prevailing in those markets (in most cases many times higher than the official rates), and by evident phenomena of “dollarisation” of the payments system.⁶ However, currency inconvertibility and, in general, administrative controls on currencies – though usually a synonym for shortage of foreign exchange – do not necessarily indicate the existence of a FE gap as conceived in the works of Hollis Chenery and his associates. Indeed, it could theoretically be maintained that in a centrally planned economy it would not be proper to talk of a FE gap since import (foreign exchange) requirements are fixed in advance according to plan priorities: planning implies an estimate of *ex-ante* amounts of hard currency earnings and of external borrowing. When a system, however, moves from traditional Soviet-type planning to more decentralized forms of economic organization (that is, when single decision-makers are able to fix the level of their imports and of their demand of foreign currencies), a FE gap may arise: desired import levels cannot be realized because of a structurally scarce hard currency supply. In this context, FFA and any other institutional arrangement that can help to save hard currencies is of decisive importance.

Subsequently, theoretical, empirical and ideological considerations led to a fragmentation of views on the FFA problem. In particular, and maybe as a reaction to earlier optimism, the likelihood of adverse consequences of external aid on the recipient country was explicitly analyzed. FFA was judged, at least potentially, as harmful for the process of domestic savings creation and a factor somewhat distorting the proper interplay of market forces.⁷

At present, aid is considered effective under specific conditions and particularly if it involves – either directly or through conditionality – institutional changes and structural reforms that can help the recipient country to proceed towards self-sustained growth. The importance of aid, therefore, is thought to depend more on its qualitative aspects than on its strictly quantitative dimensions. The experience of Taiwan and South Korea in the 1950s and 1960s is often cited as a good example of a link between aid and far-reaching economic reforms (trade liberalization in particular) capable of generating important results in terms of exports and GDP growth.

The problem of the conditions justifying the decision to grant foreign aid has always been of crucial importance and rather difficult to solve rigorously. Usually, the main motivations for receiving FFA are: a comparatively low level of per capita income (used as a proxy for level of development), alarming conditions of poverty, and short-term imbalances in the current account or in the country's general economic situation. If strictly applied, these criteria would not appear to justify the granting of aid to Central/Eastern economies. In particular the per capita income and poverty conditions

motives do not appear as strong as is usually the case in the LDC. The general reasons for helping CEE countries are to be found more in the mutual interest donor and recipient countries have in stabilizing and improving the general political and economic situation and in creating markets that can be reciprocally exploited. Politically and diplomatically, foreign financial assistance is a crucial element in the donors' foreign economic policy. This obviously applies also to the new East-West relations (the end of the cold war, mutual reduction in defense spending, etc.), as an important aspect of economic cooperation, the granting of aid should make the economic relations between donors and recipients smoother. In a medium-long term perspective, donor countries (Western Europe in particular) could benefit from the opening up and the development of huge new markets. External assistance would undoubtedly shorten the time necessary for Western countries to benefit from a higher volume of trade.

The CEE countries' experience seems to suggest that aid could help to achieve most of the benefits listed above. Given the shortage of hard currency and the need for high quality management, external assistance could be expected to make a significant contribution to the modernization of plants and farms. It could also help the economy to maintain acceptable levels of household consumption during the phase of stabilization, by improving the conditions of those sectors of the population close to a poverty situation and by promoting higher standards of education.

3. The dimensions of Western intervention in Central and Eastern Europe⁸

The quantitative dimensions of Western financial assistance to CEE countries are not negligible, though a precise estimate of Western support for the transition in Central and Eastern Europe is difficult to put together. As extensively discussed in the recent *Economic Survey of Europe* (UN-ECE, 1993b, pp. 17-18) several factors made it virtually impossible to obtain a clear statistical picture of current assistance efforts. Amounts committed are not distinguished by those effectively disbursed, concessionary loans are mixed up with bilateral and other credits at market interest rates, while grant elements may be present in some loans. Export credits and investment guarantees are calculated as part of financial assistance and some estimates seem to include debt-rescheduling.⁹

From end-1989 to mid-1992, it can be tentatively estimated that a total of about 119 billions ECU was put together for CEE countries. Bilateral assistance has been rapidly put into operation by the G-24 countries and it now accounts for more than 78% of global commitments. The EC has also

been quite fast in planning and starting its PHARE programme; initially limited to Poland and Hungary, this programme now contributes to the restructuring of ten formerly planned economies. Four main sectors of interventions were envisaged:

1. emergency relief, mostly in the form of food and medical provisions;
2. the financing of sectoral and technical restructuring of productive capacity;
3. investment in infrastructure, environment, energy saving, and training;
4. support for macroeconomic stabilization, internal and external, though this type of financing has been marginal.

Other international financial institutions have been involved very rapidly too. Not only have they been ready to accept as new members the 'old' CEE countries but also the new states born from the dissolution of Yugoslavia and the Soviet Union. They now play a crucial role – given their long experience in macroeconomic assistance and structural adjustment – in the global aid planning.

A new institution, the EBRD, has also been created, with the special aim of helping the private sector in the transitional economies.¹⁰ The main idea behind the EBRD was that private investment should become the major source of external financing. Its statute requires that the majority of its lending goes to the private sector on commercial terms, and at market rates.¹¹ In the first year of activity the Bank approved about 20 projects, committed 620mn ECU and disbursed only 72mn ECU. In 1992 it committed nearly 1,500mn ECU, disbursed 280mn ECU and invested about 160mn ECU in equity investment.

The most relevant features of Western financial contributions to the CEE countries seem to be the following:

i) The aid provided covers both technical and purely financial intervention. Macroeconomic assistance (including debt reorganization, the Polish stabilization fund, loans from the G-24 and the IMF) plays a predominant role being close to 39% of total financing (CIS-RF apart), while contributions to economic and social restructuring (included World Bank and EBRD loans) are around 28% of the same total. Lesser percentages are covered by official export credits and support for private investment (around 22%) and by emergency assistance (just above 3%).

ii) Though precise figures for 1991 and 1992 are still lacking, evidence for 1990 seems to indicate that effective disbursements from Western countries and multilateral organizations is far behind the amounts of aid officially

committed. An estimate by the UN-ECE (1992, p. 183) put the disbursal rate for 1990 – with reference only to Bulgaria, Czechoslovakia, Hungary, Poland and Romania – at 20% or even around a striking 12 per cent if debt restructuring *vis-à-vis* the West and part of the financing linked to the Polish stabilization fund are not taken into account.

iii) The quota of foreign assistance in grant form is just over 17% of the total, though if we include in the total the cancellation of Polish debt and the rescheduling of the Bulgarian one, the percentage grows to almost 30%. Thus, the greatest portion of Western aid effort is in the form of financing which, in a way or another, will require a repayment (see below).

iv) Less than 40% of total financing is directed at structural interventions while the remaining portion is committed for short-term relief, like food aid or balance-of-payments support, and export credits. This distinction, however, is a weak one since it is often rather difficult – especially in the context of the transitional economies – to draw a clear line between structural changes of the economic systems and macroeconomic policies. A currency stabilization fund, like the one devised for Poland at the beginning of 1990 and for Russia as part of the April 1993 G-7 package, supports a policy of macroeconomic adjustment, but is also crucial for enhancing credibility of structural reforms.

v) Among the donor countries the major efforts have been made by Germany and the United States which together account for more than one third of total bilateral assistance and for over 35% of overall aid. The quota of German financing in particular covers more than half of total bilateral assistance. It is also important to stress that both in the US and in the German case – though data here do not refer to the CIS and the Russian Federation – the percentage of grants on the overall assistance (over 30% and 20% respectively) is considerably higher than in the other donors' cases.

vi) Poland and, not surprisingly, the CIS-Russian Federation (CIS-RF) are by far the major recipients of committed external financing. Poland gets more than 15% of global financing if the cancellation of official external debt made by the Paris Club is taken into account. Over 60% of the entire Western financing has been committed to the CIS-RF. All this means that the aid needs of the majority of the new democracies are, at best, only partially fulfilled; this seems to be especially true for Bulgaria and Romania.

vii) Each international organization has played a different role in the CEE countries' external financing: the EC, the EIB, the EBRD, and the World Bank have stressed the support for economic and social restructuring and, especially in the case of the EC and EBRD, the funding of small-, medium-sized private enterprises. The IMF and, partially, the EC have dealt with the financing of macroeconomic stabilization.

4. External financing and conditionality

One of the most controversial issues in the debate over assistance to Eastern Europe has been the presence of conditions attached to the external intervention. In particular, given the prominent role of the Community as a donor (and as a coordinator of G-24 intervention) the debate has at times called on the application of specific criteria of conditionality or clauses to be added to those already devised by the IMF.

As noticed earlier, foreign financial assistance is considered to be more efficient when used in conjunction with other reforms or a set of policy measures aiming at stabilizing the economy in the short run. Therefore, macroeconomic conditionality – that is the link between the use of IMF's resources and specific macroeconomic policy measures requested from the country wishing to borrow from the Fund – makes up an integral part of the intervention of multilateral institutions and takes the form of measures aiming at short-term stabilization and medium-term restructuring of the receiving country.

In this respect the recent experience in Central and Eastern Europe is no exception. The granting of financial assistance to CEE countries was made conditional on progress towards economic and political reform. Eligibility criteria included a clear commitment towards the creation of a market economy, multi-party democracy and free elections, respect of human rights and the rule of law. Moreover, conditionality constrained all aspects of the *regime change*: the pace and timing of liberalization, the sequencing of reforms, the future characteristics of the economy, etc.

The practice of conditionality in Eastern Europe has to be evaluated according both to the procedures involved and to its specific contents. These, in turn, have to be seen in the light of the links and possible incompatibilities between short-term adjustments and structural reforms.

As far as the procedures of loan granting and subsequent economic monitoring of the borrowers are concerned, the IMF – in its dealing with developing countries – has been often accused of undermining their economic and fiscal sovereignty. With the possible exception of the Russian Federation, the Fund has not until now encountered similar problems in

Eastern Europe where, indeed, policies suggested by the Fund have been embraced wholeheartedly by the new governments. The attitude towards the IMF could however change – with the demand by the borrower of less rigid macroeconomic conditions – in case of an accentuated worsening of the real side of the economy and of the living conditions of the population.

A problem which has been raised recently refers to the need of coordinating conditionalities coming from different international bodies. This is quite a serious matter since conflicting targets or a different emphasis on specific policy instruments can be detrimental to a clear economic policy path. However, it should be stressed that the IMF's conditionality has rapidly become, with few exceptions, the conditionality of other multilateral organizations. The EC, for instance, links much of its financing to the existence of an agreement of the borrower with the Fund. More in general, without a decent relationship with the IMF, the access of a country to private international financial markets is virtually impossible: conditionality has become a sort of 'certificate of creditworthiness', necessary – in the minds of bankers and politicians of lending nations – to diminish the country's risk.

Having taken into account these observations, the evaluation of the content of conditionality has to be more articulate. No substantial objections can be put forward on the main targets of conditionality: the presence of a macroeconomic environment characterized by low inflation and exchange rate stability makes the setting of the entire transformation process less uncertain, especially considering the new and crucial choices that both private agents and governments have to make in the transitional economies. It is indeed hard to imagine that enormous changes such as privatization and demonopolisation can effectively be realized while inflation is running high and the exchange rate is constantly depreciating. Granted that, what has to be carefully assessed is the degree of compatibility between restrictive macro policies and the more general process of economic liberalization.

In the first place, it is commonly maintained that monetary policy has to be very strict, in the aftermath of price liberalization, with the aim of avoiding the beginning of a chaotic 'catching-up' game among liberalized prices. The latter, however, does not consist of a once-and-for-all 'jump' of the general price level; indeed, its very nature requires that a certain amount of time elapses before the structure of relative prices can reach some equilibrium. Inflation from liberalization is thus bound to go beyond the few months optimistically forecasted by a number of economists. In this context, highly restrictive monetary and fiscal policies aimed at a drastic reduction in the inflation rate can quite likely imply unduly heavy costs in terms of incomes and employment.¹²

Similar arguments can be made concerning the degree of compatibility between trade and currency reforms on the one hand and stabilization on the other. Import liberalization and the larger access to foreign currencies could in fact create an extremely fragile situation on the current account side. External equilibrium could be reached or preserved – even in this case – only with a strong contraction of aggregate demand. Moreover, the real exchange rate appreciation – due to persistent inflation – brings about, sooner or later, currency devaluations with new negative consequences on the price level.

These observations lead to the most relevant element of a critique of a financial aid strategy essentially based on the principle of IMF conditionality: the deep gap between the rigid monetary control of the economy and the long-term features of Eastern transition and the related necessities of assistance. From this point of view, the optimistic and even naive expectations of a rapid transformation of CEE countries have now disappeared. This new awareness should have brought Western government and institutions to a massive, coordinated and balanced technical and financial effort, something which, as we have seen, has not happened.

5. A preliminary assessment

On top of its inadequacy Western intervention has also been criticized for a number of other reasons. A very small portion (around one fourth) of external assistance is provided in the form of grants or concessionary finance. A large share of the total amount provided is accounted for by 'special financing' or by debt rescheduling. Obviously this is an important short term relief, but does not cancel the obligation to service the debt in the longer period. Furthermore, a large part of the assistance itself is debt creating: the provision of loans at market (or quasi-market) conditions is likely to increase the financial burden on the transitional economies in the long run.¹³ According to the UN-ECE (1993, p. 19), the balance between debt servicing and capital inflow in 1992 actually represented a net outflow of resources for most of the CEE countries. The moderate increase in imports from Western markets can be ascribed mostly to the parallel increase in exports, while foreign resources seem to have done very little to support investment and consumption in the area.

The coordinating role attributed to the EC more than three years ago has avoided duplication of efforts in specific sectors or industries but up to now it has not meant a planned effort to distribute the flows of available international resources to the CEE countries. A new institutional body – like the Assistance Coordination Council proposed by Anthony Solomon,

Raymond Barre and others,¹⁴ with the participation of all international economic institutions, the EC, EFTA and representatives of the G-7 and of CEE countries – working in close cooperation with the recipient countries would undoubtedly contribute to a more efficient distribution of resources.

It was assumed at the beginning of the transition that debt relief would have been part of the overall aid strategy for CEE countries. Debt relief, instead, has been provided so far only to Poland (13.2mn ECU for official debt cancellation). Other countries (e.g., Bulgaria) have reached agreements with the Paris Club for the rescheduling of their external debt, which however do not include substantial writing off of loans. Debt relief, would have been an immediate way to soften the hard currency constraint.¹⁵ Debt restructuring, aimed at lightening the burden of external payments in the short-medium term, could have also helped to achieve a more sustainable equilibrium of trade and current account and could have allowed a higher volume of imports in the transition phase.¹⁶

Finally, inefficiency in the use of aid has been reported. This problem arose particularly in conjunction with emergency relief (mostly food and medical provisions) which has characterized the early phase of Western intervention. The lack of distribution channels different from the old bureaucracy has often been an obstacle for targeting aid to the needy strata of the population, avoiding waste and the illegal use of assistance.

A problem of its own is represented by an assessment of the effective capacity of CEE countries to absorb and fruitfully use substantial amounts of external assistance, particularly for the poor state of market infrastructure. This has led some observers to advocate massive injections of technical assistance, which, more than grants and loans, should have constituted the bulk of Western assistance.¹⁷ While technical assistance has indeed represented a large part of the G-24 assistance to transitional economies (although quite difficult to quantify precisely), the nature of the intervention seems once more based on a case by case approach and not linked to a coherent programme drawn up in accordance with the countries concerned.

6. Western protectionism and market access

The remedial measures which the Central and East European countries have attempted to apply to their trade crisis involve a considerable intensification of trade relations with the more industrialized countries of the West, above all with the members of the European Community. Indeed, recent trends in CEE countries' trade are characterized by a gradual transformation of the commodity pattern of trade: re-orientation in the geographical distribution

of trade and, to a more limited extent, towards exports of products that are more competitive at the international level.

However, the concrete opportunity for Central and East European exports to penetrate Western markets is limited by a number of factors. First, trade is hampered by the low level of competitiveness of the exporting countries. Second, the difficulties and uncertainties inherent in the current transition render the emergence of an efficient export sector highly problematic, at least in some countries. Those difficulties sum up to the strong desire to escape from a system of trade and regional cooperation entirely based on central planning and barter trade. Finally, the attempt to re-orientate a large part of their export finds an obstacle in Western protectionism.

As mentioned above, Western Europe acts as a powerful pole of attraction – especially as a result of the new institutional arrangements associated with the creation of the single market – insomuch as it is seen as a large and wealthy free-trade area, and as the locus of the free-market economy. Trade and commercial relations with the EC are considered of enormous importance for CEE countries. Between September 1988 and October 1990 General Trade and Economic Cooperation Agreements, also known as “first generation agreements”, were signed by the EC and all CEE countries. The agreements provided for the removal of quantitative restrictions, although gradual and incomplete, extended the Generalized System of Preference (GSP) to the reforming economies and paved the way for further negotiations.

A new basis for trade and cooperation was laid by the so-called “Europe Agreements”. Agreements establishing an association between Hungary and Poland and the EC were signed in December 1991 and came into force in the Spring of 1992 on an interim basis pending ratification.¹⁸ Similar agreements have been negotiated with Bulgaria and Romania and should come into force in the Summer of 1993. Separate renegotiations are taking place with the Czech and Slovak republics, following the division of the country.

The agreements aim to establish a free trade area between the Community and the CEE countries over a transition period lasting no longer than 10 years, in two five-years stages and including a medium-term review, which, however, does not apply to trade aspects. Trade liberalization rests on the concept of *asymmetry*, i.e. the liberalization path of the CEE countries will be slower than the EC. Quantitative restrictions are abolished, with the exception of coal and textiles. Tariffs are also abolished on half of EC imports from CEE countries. Tariffs on the remaining products will be abolished during a period of five years, with the exception of textiles¹⁹ and for iron and steel, where Voluntary Export Restraints (VERs) have been arranged. Rules of origin envisage a minimum 60% local content, and anti-

dumping protection is reiterated and possibly reinforced. The most difficult and controversial part of the Agreements deals with agricultural products, since the Common Agricultural Policy constrains trade liberalizations and concessions. In this sector the EC adopted the principle of 'near' reciprocity for a number of sensitive products, *de facto* postponing a fuller opening of the EC market.

The Agreements are also intended to provide a framework for political dialogue, and to set up conditions for the Community's financial and technical assistance. On top of the commitment to the free movement of the goods, services, labour and capital, there are provisions for a progressive harmonization of CEE countries legislation with EC rules, and the adoption of EC technical standards. Liberalization of capital movements is gradual and strongly regulated, while the agreements do not guarantee access for workers beyond what is guaranteed bilaterally by EC member states.

The agreements recently signed with Bulgaria and Romania contain a special provision concerning democratic principles and human rights,²⁰ which allows for a possible suspension of preferential trade relations in the case of significant human rights abuses or a turn around in economic reform. This particular safeguard clause implies a less liberal attitude towards asymmetric liberalization, with further limitations above and beyond those already existing for the Visegrad countries.

The agreements have been criticized on the ground that they do not facilitate the economic integration of the CEE economies into West European markets. Despite the asymmetry in trade liberalization in favour of the transitional economies, short- and medium-term benefits are likely to accrue primarily to the EC. Moreover, they do not indicate clearly when the goal of eventual membership of the Community could be realized, nor do they set out in detail the conditions to be fulfilled by the perspective members. Nuti (1993, pp. 9-11) singles out three main obstacles on the way to a closer integration than that envisaged in the Association Agreements:

- i) The existence of excess capacity in some sectors (e.g. iron and steel and chemicals) where the EC has intervened in the past with plans of concerted and assisted capacity reduction.
- ii) The Common Agricultural Policy whose extension in its present form to CEE countries would represent a very heavy burden for the EC budget.²¹
- iii) The presence of dumping, linked to the persistence of forms of state aid, domestic price controls, underpricing of energy and overvaluation of currencies.

Closer association of CEE countries or even membership could not bypass these structural problems. Furthermore, their current low level of per capita income would put an enormous strain on the system of EC structural funds, and on all other forms of development assistance within the Community. An increase in the GDP level seems therefore a necessary condition for accession to the EC.

The experience of the last three years seems to indicate that, on the whole, market access to the EC has remained highly regulated and subject to a delicate balance between the general principle of free trade, the heavy pressures of sectoral and national interests within the EC and concessions to external forces. The remaining obstacles to free trade, mostly concentrated on sensitive sectors, can seriously hamper the overall future performance of CEE countries. Particularly if we consider that those sectors and products which seem to be most heavily affected by the remaining trade barriers are the sectors CEE countries seem to rely on in order to gain shares in Western markets. Preliminary evidence (see Daviddi, 1992) clearly indicates that CEE countries' exports 'competitiveness' *vis-à-vis* the EC appears concentrated on primary products and intermediate manufactures. Since in the short run, it is difficult to foresee any sudden shifts away from the existing export matrix, the permanence of obstacles to trade can be detrimental to the entire transition process. Vice versa conditions of freer trade would allow the CEE countries to gain substantially from the new trade arrangements with the EC.

However, a paradox which seems to characterize the present situation needs to be stressed. In the short run CEE countries would like to trade much more with the West and much less with their old partners, but in both cases they are unable to do so, at least to the extent desired. In the long run, that is by the time the transition to the market will be more advanced and the technological and qualitative level of goods improved, there is no reason for individual CEE countries to discriminate against their neighbours; indeed, there would be many advantages to tightening commercial links among them. The agreement signed in December 1992 in Krakow between four central European countries (Poland, the Czech Republic, the Slovak Republic and Hungary) seems a step in the right direction.²²

7. Conclusions

Despite the speed in implementing new institutions and programmes and the involvement of the IMF and the IBRD, Western intervention so far has fallen short of many of its objectives in the CEE countries. Too small a portion of total aid has been given in the form of grants, effective

disbursements have been much lower than commitments and debt relief has been applied almost uniquely to Poland. IMF's conditionality and related short-term policies have played an excessively prominent role. In this respect Western governments should revise the focus of their intervention, by substantially enlarging available resources for agricultural and industrial restructuring and for the protection of those parts of the population more severely hit by the hardship of the transition.

A possible interpretation for the insufficient support of CEE economic transition sees as a main cause the present phase of stagnation and recession of West European economies. In this view the blows to economic integration brought about by the difficulties in ratifying the Maastricht Treaty and by the – partly ensuing – September 1992 currency crisis have created an inward-looking, divided and protectionist-prone EC. This interpretation partly corresponds to reality; however, one should not conclude that a rapid recovery of the West European economies would remove the obstacles to a much stronger support of the new Eastern democracies. Indeed, the EC's present conditions of high and widespread unemployment and the need to keep the state budgets under strict control will not leave enough public resources available for the restructuring of Eastern Europe and will not ease the process of trade liberalization towards CEE countries.

A number of considerations, geographical proximity aside, prompted the Community to intervene. First, the rapid pace of development of CEE countries and their closer integration with the EC was perceived as working against the consolidation of areas of social tensions contiguous to the Community. Second, the process of transformation and development in CEE countries was thought to constitute one of the major sources of growth of EC external trade over the next ten years. Finally, a high rate of growth in the transitional economies, and possibly a closing of the gap among the two areas was judged as deterrent against flow of immigration from CEE countries towards the EC.

Those considerations have kept intact their relevance and should still push the Community, and Western institutions in general, to strengthen their efforts to provide adequate economic assistance to the CEE area.

Total Assistance Committed to Central-Eastern Europe
(1990 – Mid-1992, Millions of ECU)

| | Total | EC(1) | EFTA | Other G-24 | IMF | WB | EBRD |
|----------------------------|---------|--------|-------|---------------|-------|-------|------|
| Albania | 727 | 570 | 10 | 114 | – | 32 | 1 |
| Bulgaria | 2,128 | 846 | 112 | 240 | 655 | 235 | 40 |
| Czechoslovakia | 5,082 | 2,455 | 191 | 647 | 1,181 | 528 | 80 |
| Hungary | 7,888 | 3,681 | 189 | 1,154 | 1,687 | 950 | 226 |
| Poland | 18,175 | 6,595 | 1,096 | 6,187 | 2,215 | 1,958 | 124 |
| Romania | 4,175 | 1,604 | 109 | 335 | 1,102 | 803 | 222 |
| Ex-Yugoslavia | 3,212 | 2,127 | 85 | 61 | 67 | 873 | – |
| Regional/Unspecified | 5,184 | 3,012 | 1,773 | 367 | – | – | 33 |
| <i>Total</i> | 46,573 | 20,890 | 3,565 | 9,103 | 6,906 | 5,380 | 727 |
| Estonia | 137 | 33 | 75 | 29 | – | – | – |
| Latvia | 132 | 56 | 48 | 28 | – | – | – |
| Lithuania | 125 | 64 | 31 | 29 | – | – | – |
| <i>Total Baltic States</i> | 393 | 153 | 154 | 87 | – | – | – |
| CIS (2) | 71,821 | 52,416 | 1,186 | 16,903(3) | 720 | 511 | 83 |
| <i>Grand Total</i> | 118,785 | 73,459 | 4,904 | 26,094 | 7,626 | 5,380 | 810 |

Source: EC, *Breakdown of World Assistance to the Independent States of the ex-USSR*, November 1992; EC, *G-24 Scoreboard*, various issues.

1) Included direct EC, EIB, CECA financing.

2) Data cover period beginning 1990 - November 1992.

3) Included countries other than G-24.

Notes

1. For the purpose of this study the term Central and Eastern Europe will include: the Czech Republic, Hungary, Poland, the Slovak Republic – increasingly referred to as Visegrad countries – Bulgaria, Romania and former Yugoslavia. However, reference will be made also to the CSFR since the splitting occurred after the beginning of many assistance programmes.
2. For instance, according to the United Nations Economic Commission for Europe, in Russia the number of people officially classified as living in poverty more than doubled in 1992, from 12% to 29% of the population. Cf. UN-ECE, 1993b, p. 4.
3. The most essential contributions to the aid literature of the 1950s and 1960s have been collected in Bhagwati and Eckaus (1970) while four more recent volumes undertaking a thorough examination of many of the issues raised by FFA are by Cassen and associates (1986), Riddell (1987), Krueger et al. (1989) and Lele and Nabi (1991). An excellent recent survey can be found in Eaton (1989).
4. The literature on the “savings gap” is based on the growth models of the Harrod-Domar tradition. See, for example, Rosenstein-Rodan (1961a). The fundamental contributions on the FE gap are by Hollis Chenery and several associates. See Chenery and Bruno (1962) and Chenery and Strout (1966). Lucid expositions of this theory and related issues have been carried out by McKinnon (1964) and Findlay (1971).
5. Cf. Mikesell (1968) pp. 99-104 for more detailed references.
6. For a theoretical analysis of hard currency shortages in centrally planned economies, see Holzman (1978) and Desai and Bhagwati (1979).
7. A radical critique of FFA is contained in Bauer (1972); see also, among many other contributions, Bhagwati, Brecher and Hatta (1984) and Van Wijnbergen (1986).
8. This section draws on Espa, 1992b.
9. Information supplied to the international organizations (the OECD is supposed to provide official information also on development assistance to CEE countries) is incomplete, and made available with great delay. The latest official estimates for total gross financial flows including grant and concessional financing are for 1990.
10. The proposal to set up the Bank met considerable criticism, since it was seen as an unnecessary duplication of scope and functions of the IBRD.
11. Although recently, proposals have been put forward aiming at the creation of a special restructuring facility which would grant ‘soft loans’ – i.e. below market interest rates – to finance projects of particular importance.
12. On these issues, see Davididi, Espa and Uvalic (1992) for a more comprehensive treatment.

13. For a critique along similar lines see Mihalyi and Smolik (1991).
14. Cf. Institute for East West Studies (1992).
15. The relevance of this issue is discussed in Kenen (1977). See also Portes (1991) for an assessment of its relevance in the case of CEE countries.
16. An alternative path could have included the provision of funds for the establishment of a Central European Payments Union (CEPU) – an option that we have discussed at length elsewhere (cf. Daviddi and Espa, 1992) – which, however, has been *de facto* ruled out by the strong opposition of policy makers in the countries concerned eager to abandon as soon as possible the old regional system of political and economic relations.
17. See for instance UN-ECE, 1990, pp. 15ff.
18. The agreements are subject to a lengthy process of ratification, since they need to be ratified by the twelve member countries collectively and individually.
19. In this case the phasing out period can be longer, up to half the period agreed in the Uruguay Round to phase out MultiFiber Agreements.
20. Article 6 of the interim agreement with Romania reads: “Respect for the democratic principles and human rights established by the Helsinki Final Act and the Charter of Paris for a New Europe, as well as the principle of market economy, inspire the domestic and external policies of the Parties and constitute essential elements of the present association.” CEC (1992), p. 5.
21. The existence of even higher forms of agricultural protectionism outside the EC suggests that the problem cannot be solved adequately through bilateral negotiations. Furthermore, the effective competitiveness of CEE agriculture at world market prices is open to question.
22. The agreement, which concludes a process initiated in 1990 with a summit in Visegrad, aims at establishing a free trade zone from March 1, 1993, although trade barriers will be phased out gradually until 2001. For a brief review of the contents of the agreement see *East West Fortnightly Bulletin*, 541, January 1993, pp. 2-4.

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